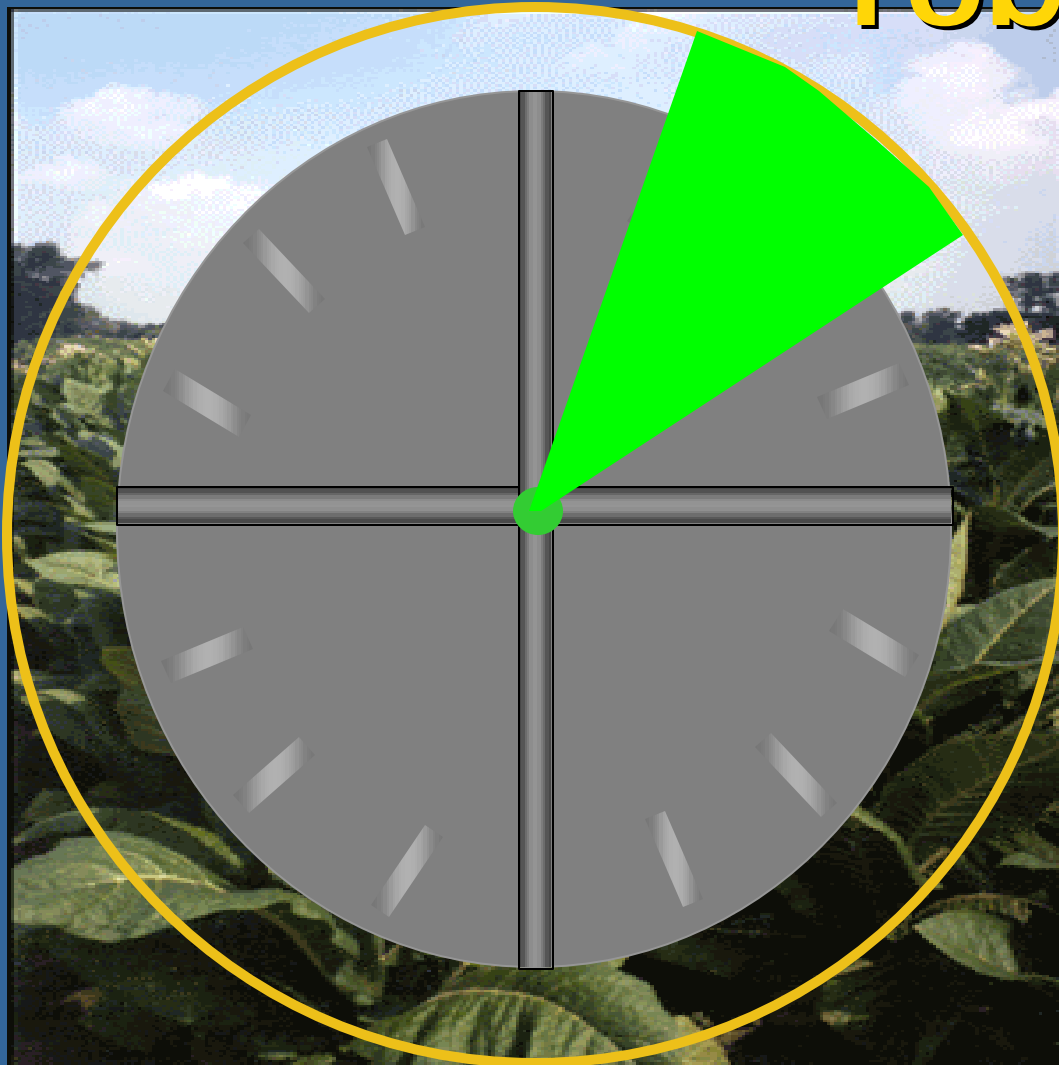


Tobacco Issues: Contracting & Use of Tobacco Settlement Payments

Kelly H. Tiller

USDA Agricultural
Outlook Forum
February 23, 2001





Legal & Political Issues

- \$145 Billion Engle Judgment In Florida
- Over 500 Active Lawsuits
- Tobacco Growers' Lawsuit
- DOJ Suit Losing Momentum
- FDA Authority Over Manufactured Products
- President's Tobacco Commission Report



Program/Marketing Issues

- Widespread & Rapid Growth Of Contracting
- Program Continuation Referenda
- Much Lower Quotas
- Growing Pressures On The Auction Warehouse System
- Renewed Interest In Buyout And License/Permit System
- Pool Stock Quality Issues



Production/Grower Issues

- Contracting
- Infusion Of Payments To Growers And Quota Owners
 - Phase II, TLAP, MSA
- Quota Lease Costs Continuing To Increase
- Curing Processes To Reduce TSNAs



Trade Issues

- Declining Exports Of U.S. Leaf
- Increasing Imports Of Foreign Leaf
- Declining Use Of Domestic Leaf In U.S. Cigarettes
- Pricing Of U.S. Leaf In International Markets
- Increasing Cigarette Manufacturing Capacity Offshore
- Recent Opening Of China To Tobacco Trade



Health & Product Issues

- Introduction/Development Of New Products
 - Lower TSNAs
 - Reduced PAH Compounds
 - Low-Nicotine Products
- FDA Authority Over Manufactured Products
- WHO Framework Convention On Tobacco
- New Medicinal & Biopharmaceutical Uses For Transgenic Tobacco



Tobacco Contracting

Tobacco Contracting: Background

- Tobacco Contracting Idea Is Not New
- Smokeless Tobacco Types Are Often Direct Purchased
- Track Record With Some Specialty Tobacco Companies
- Some Leaf Dealers Purchase Tobacco For Export Directly Or Through Producer Contracts

Tobacco Contracting: Outside U.S.

- Marketing Contracts, Production Contracts, And Vertical Integration Are Much More Common For Foreign-Grown Tobacco
 - 81% Of All Flue-Cured & 54% Of All Burley in 1998
- Lack Of Access To Production Inputs, Capital, Management Skills, Technical Assistance
- Lack Of A Tobacco Program Or Other Risk Management Tools

Tobacco Contract Evolution

- PM Introduced The Idea In 1999, Implemented In Burley In 2000
 - Nearly 1/3 Of Burley Crop Contract Marketed In 2000
- Flue-Cured Contracts For Lower-TSNA Tobacco In 1999
- Contract Programs Expanding To Flue-Cured In 2001
 - PM, RJR, B&W, Lorillard
 - 50% Or More May Be Contracted In 2001?

Tobacco Contracts Today

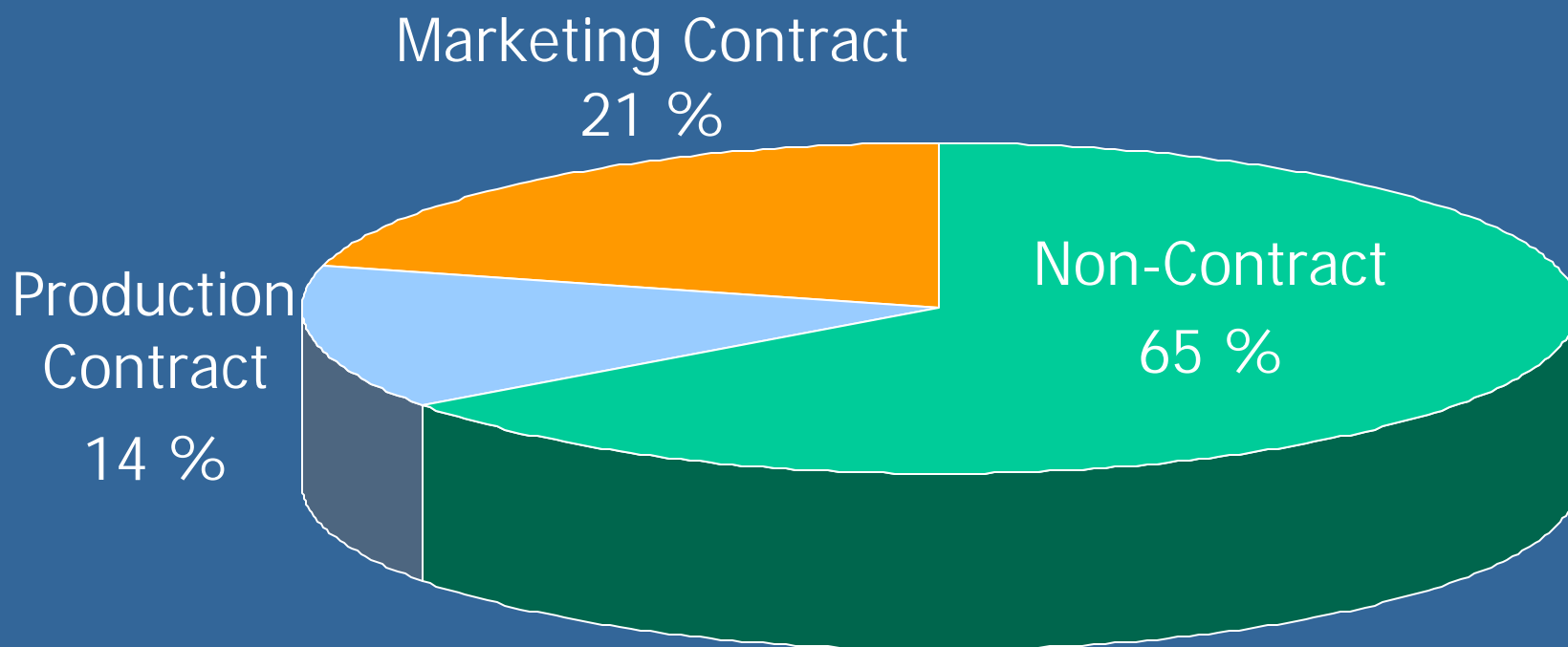
- Generally A Marketing Contract, Some Production Requirements
- Single Year Or Three-Year Contract Period
- Covers All Of A Grower's Production, All Stalk Positions, Contracted Quantity Is Determined Prior To The Marketing Season
- Specifies Origin, Receiving, Weighing, Inspection, Grading, Price Schedule & Rejection
- Contracted Pounds Deducted From Marketing Card, Assessments Paid, But Not Warehouse & Grading Fees

Manufacturer Incentives

- Contract Production Could Provide Manufacturers With The Specific Qualities They Need, Especially As Quotas Decline
- Over Time, Growers Would Have Incentive To Increase Tobacco Quality
- Would Speed The Adoption Of Technological Change
- In The Event Of FDA Regulation Over Manufactured Tobacco Products, Contracting Would Allow Tighter Management Control & Provide Accountability
- Without The Auction System, Could Reduce Costs Significantly



Value of Contract Agriculture



All Agriculture: \$192 Billion

Value Of U.S. Agricultural Production Under Contract

Commodity	Share of Contract Production (%)	Share Produced Under Contract (%)
Poultry	24	95
Fruit	9	57
Dairy	23	55
Cotton	3	51
Vegetables	8	45
Hogs	6	43
Cattle	12	25
Corn & Soybeans	7	13

Producer Contract Advantages

- Reduces Price And/Or Production Risks
- Market Access
- Improve Efficiency
- Access To Inputs & Capital
- Technical & Managerial Advice
- Cash Flow Management
- Income Stability
- These Are Not Significant Problems In Tobacco
 - TOBACCO PROGRAM
- Price Stability At The Expense Of Quota Instability

Program Contracting Issues

- Can The USDA Grading Service Be Supported?
- Will The Auction System Become An Outlet For Lower Quality Tobacco?
- Relationship Between Contracting & Auction Market Prices?
- Consolidation/Elimination Of Warehouses?
- Quota Enforcement? Assessment Collection?

Contracting Within The Program

- Growers' Cost Saving From Contracts Eventually Passed On To The Quota Owner
- As Quality Improves, Buyers' Cost Savings Eventually Translated Into Higher Tobacco Quotas
- Unclear To Whom Contracts Will Be Awarded In Long Run
 - Number Of Contract Growers
 - Location Of Growers
 - Size Of Contract Operations

Contracting Outside The Program

- Cost Savings Without A Program Are Transferred To Buyers
- As Quality Increases, Buyers' Cost Savings Are Translated Into Larger Quantities Purchased
- Contract Growers Would Bear Contract-Specific Risks
 - Risk Of Growing Tobacco That Doesn't Meet Quality Standards
 - Risk Of Not Having Contracts Renewed
 - Investment And Income Risk
- Fear Of Lack Of Competition For Contracts

Contracting Outside The Program

- Small Yield Fluctuations Could Make It Difficult To Cover Costs Of Production
- Lower Priced U.S. Leaf May Be More Competitive
- Will There Be Sufficient Competition Among Buyers/Leaf Dealers To Ensure Global Competitiveness?
- Lack Of Market Information Without Disclosure

A photograph of a large field of tobacco plants, with the text "Master Settlement Agreement" overlaid in the center. The plants are green and leafy, growing in rows. The background shows a dense line of trees.

Master Settlement Agreement

Master Settlement Agreement

- \$206 Billion Over 25 Years To 46 States
- No Restrictions On State Spending Of Payments
- Payments Made To Each State's General Fund, Decision Making Generally Left To Legislatures
- All States Have Allocated Some Portion To Health Priorities, Most Allocated Some To Tobacco Use Prevention, Many To Education
- Most Tobacco-Growing States Have Allocated Some To Agriculture And/Or Rural Communities

North Carolina

MSA Payments

- \$200 Million To Date, \$4.8 Billion Total
- Legislation Passed In March 1999 Allocating Settlement Payments Among 3 Nonprofit Funds
- 25% To A Tobacco Grower Trust To Compensate For Economic Losses, Possible Uses Include:
 - Assisting Tobacco Farmers With Barn Conversions
 - Scholarships For Growers & Their Dependents



North Carolina

MSA Payments

- 25% To A Health Trust For Unspecified Health Issues
- 50% to Golden LEAF Foundation To Provide Economic Assistance To Tobacco Dependent Communities
 - Using Only Investment Income To Fund Projects
 - Awarded \$5 Million To 39 Projects in 2000 (400 Proposals)
 - Including Alternative Crops, Education, Research, Economic Development & Alternative Employment
 - Most Of The Awards Target Flue-Cured (Eastern) Regions



MSA Payments

- \$150 Million To Date, \$3.5 Billion Total
- Through 2002, 50% To Agriculture, 25% To Early Childhood Education, 25% To Health
- \$69 Million Reserved For A "Bucks For Brains" Program
- General Assembly Will Revisit In 2002



MSA Payments

- \$180 Million In Agriculture Fund Through 2002
 - \$40 Million To Shore Up Phase II (\$114 Million)
 - \$49 Million To County Ag Councils
 - Local Uses Such As Low Interest Loans, Water Line Grants, Transitioning To Alternative Enterprises, Environmental Stewardship
 - \$91 Million For Statewide Ag Development
 - Such As Regional Farm Markets, Small Farm Diversification, Environmental Compliance Cost Share, Municipal Water, Farmland Preservation



Tennessee

MSA Payments

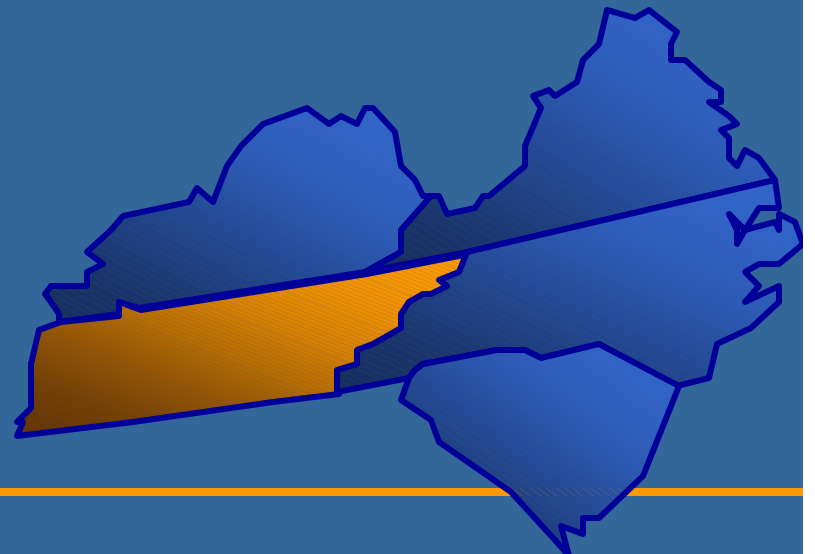
- \$200 Million To Date, \$4.8 Billion Total
- In 2000, Split Payments 50/50 Into A Health Fund And An Agriculture Fund
- Agriculture Committee Recommended Using \$60 Million To Fund Agricultural Development Programs & Educational Assistance Programs
 - Alternative Ag Development, Agribusiness Infrastructure, Ag Processing Facilities, Market Development, Production Efficiency



Tennessee

MSA Payments

- Also Recommended
 - Half Of All Future Payments Go To Agriculture
 - Endowment Approach To Future Ag Fund Allocations
 - Bond Issue Backed By Future Income Stream
- Legislature Must Act On Recommendations This Spring
- Recommendations Will Compete With Budget Shortfall



Virginia

MSA Payments

- \$167 Million To Date, \$4 Billion Total
- 10% To Youth Tobacco Prevention
- 40% To General Fund
- 50% Of All Funds To Tobacco Indemnification & Community Revitalization Fund
 - Fund Is To Provide Direct Compensation To Growers/Quota Owners For Lost Quota
 - Also Funds Economic & Agricultural Development In Tobacco Dependent Communities



MSA Payments

- \$62 Million From Tobacco Fund Paid To 42,000 Growers/Quota Owners To Date
 - Based On 1996-98 Average Quota, Same As Phase II
 - Initial Grants From The Tobacco Fund
 - \$6 Million To 7 Community Colleges In Southwest VA
 - \$11.6 Million To VA Tech For Plant & Animal Genetics Research Institute
 - \$2 Million To CropTech For Tobacco Biopharmaceutical Research
 - Economic Development Projects In Southside & Southwest VA



South Carolina

MSA Payments

- \$100 Million To Date, \$2.3 Billion Total
- 73% To Health Care
- 12% To Water & Sewer Infrastructure Projects (Mostly Rural Areas)
- 15% To Compensate Growers & Quota Owners For Production Losses
- Proceeding With Securitization



Other States

MSA Payments

- **Georgia:** \$62 Million To Rural Economic Development In South Georgia, \$22 Million For Future Projects
- **Maryland:** \$11 Million To A Tobacco Buyout Program
 - Pays \$1/lb Annually For 10 Years Based On 1996-98 Average
 - Must Stop Growing Tobacco, Must Stay In Agriculture
 - 68% Of Growers Have Applied
 - Considering A Bond Issue To Fund Buyout Up Front
- **Ohio:** 2.3% Over 12 Years (\$229 Million) To Tobacco Farmers & Their Communities

Phase II Of The Settlement



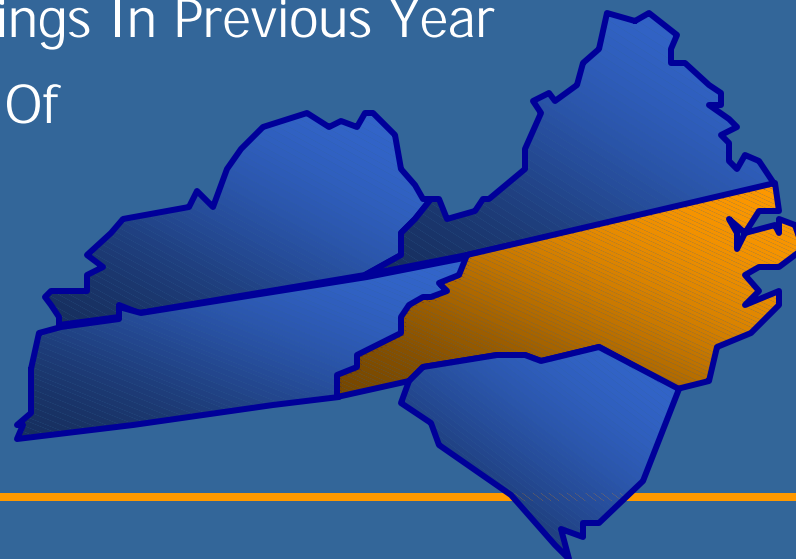
Phase II

- National Tobacco Growers' Settlement Trust To Pay \$5.15 Billion To Tobacco States Over 12 Years
- Payments To States Based On 1998 Quotas
- Only Use Is Direct Payments To Quota Holders And Producers Of Cigarette Tobaccos
- Each State Responsible For Allocation Guidelines
- Flue-Cured Payments Generally Split Evenly Between Growers/Owners, Burley Weighted Toward Growers

North Carolina

Phase II Payments

- \$232 Million Through 2000, \$2 Billion By 2010
- **Flue-Cured:** Split 50/50 Between Quota Owner & Grower
 - Payments Based On Lost Quota In The Payment Year
- **Burley:** Split 50/50 Between Quota Owner & Grower
 - Grower Payments Based On Marketings In Previous Year
 - Owner Payments Based On Pounds Of Lost Quota In The Payment Year



Kentucky

Phase II Payments

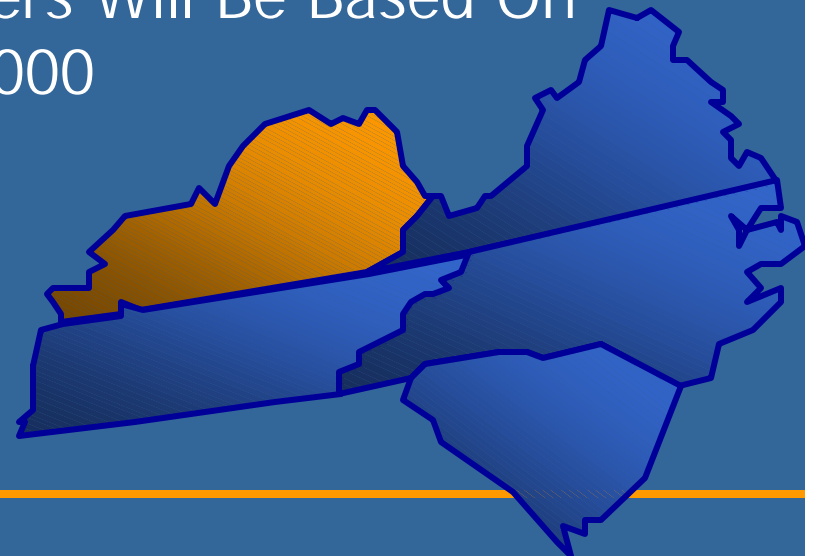
- \$193 Million Through 2000, \$1.5 Billion by 2010
- Additional \$40 From MSA In 2000 To Hold Payments Constant
- 1/3 Each To Growing Farm, Grower/Tenant, Quota Owner
- Payments To Growing Farm & Grower/Tenant Based On Avg. Of Previous Year Marketings & Effective Quota



Kentucky

Phase II Payments

- Payments To Quota Owner Based On Basic Quota In The Previous Year
- Future Payments To Growers/Tenants & Growing Farms Will Be Based On 1998-2000 Production History, Averaging Effective Quota & Marketings
- Future Payments To Quota Owners Will Be Based On Basic Quota Owned As Of July 2000
- Payments Are Driving Up Lease Costs, Keeping Farmers In Tobacco Production



Tennessee

Phase II Payments

- \$48 Million Paid To More Than 68,000 Through 2000, \$390 Million By 2010
- 80% To Tobacco Growers, 20% To Quota Owners
- Grower Payments Based On Actual Marketings In The Previous Year
- Quota Owner Payments Based On Basic Quota In The Previous Year
- Considering Fixing Payments To A Base Year(s)



Phase II Payments

- \$44 Million Through 2000, \$357 Million By 2010
- **Flue-Cured:** Payments Split 50/50 Based On Basic Quota In 1998
- **Burley:** 75% To Growers Based On Average Of Effective Quota & Marketings In 1998, 25% To Quota Owners Based On Basic Quota In 1998
- Base Year Fixed At 1998 Through 2004



Other States

Phase II Payments

- **Georgia:** \$62 Million To Rural Economic Development In South Georgia, \$22 Million For Future Projects
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